

Domestic Petroleum Council

November 4, 1997

BY FACSIMILE (303) 231-3194 AND OVERNIGHT MAIL

Mr. David S. Guzy
Chief, Rules and Publications Staff
Minerals Management Service
Royalty Management Program
Post Office Box 25165
MS 3101
Denver, CO 80225-0165

Re: Response to Notice, 62 Fed. Reg. 49460 (Sept. 22, 1997)

Dear Mr. Guzy:

The Domestic Petroleum Council ("DPC") has participated in the workshops which the Minerals Management Service ("MMS") has sponsored this month on alternatives to the initial and supplemental proposed rules on valuing royalties on crude oil from federal leases. The large independent members of DPC, which collectively produce some thirty-five percent (35%) of all U.S. crude oil produced by independents, welcome the opportunity to comment on issues raised in those sessions.

1. VALUATION OF OIL BASED ON AN AFFILIATE'S DOWNSTREAM RESALE PRICE.

The superior method of valuing royalties from non-arm's-length transactions is the lease market benchmark system DPC has previously proposed. As discussed during the workshops, elements of this system require additional definition and fine-tuning to achieve enhanced certainty and simplicity. A focused effort by industry and state and federal government representatives in workshop-type meetings can accomplish this task. Clearly a valuation system which directly measures the value of oil at the lease and meets the goals of certainty and simplicity is worth the effort.

If, however, MMS is going to continue considering affiliate resale prices in royalty computation, it must address the issue of midstream marketing. It is impossible for DPC to overstate the importance of this issue to its members. A large number of DPC members have affiliates engaged in midstream market activities.

In our comments filed last May, DPC explained in detail the additional risks and costs assumed when a producer's affiliate markets oil downstream from the lease. In addition, as part of its workshop participation, DPC initiated a survey concerning midstream marketing activities which add value beyond the value at the wellhead/lease. (Attachment 1 summarizes those risks and costs.) Although state representatives at the workshops thought deducting the costs of midstream activities was appropriate, MMS refused to consider the topic. For the most part, these costs can be included among the deductions for transportation traditionally allowed by MMS. Some revision to the transportation allowance regulations will, however, be required to accomplish this clarification. Further, additional allowance regulations should be adopted to include the costs of midstream marketing activities which are not covered by the revised transportation allowance.

Also, the MMS should eliminate the single exchange provision. It is very often necessary to enter into multiple exchange (buy/sell) agreements to reposition the oil into the optimum market place as perceived by the marketer. Although the need to allow for multiple exchanges is frequently required in Outer Continental Shelf leases, it is also used on the onshore leases.

2. DUTY TO MARKET.

DPC does not wish to belabor points it has previously made through repetition here, so it incorporates by reference its May 1997 explanation of the history of the Department's position on the duty to market. As noted there, there has never been an express or implied "duty to market" crude oil. Even as to natural gas, the "duty to market" recognized by the IBLA has not extended to costs and benefits unique to midstream activities. MMS's position on the duty to market overshadows all other concerns raised by MMS's proposals for rulemaking. Lessees selling oil at the lease at arm's length must be allowed to rely on their gross proceeds as the value of production and not be subject to after-the-fact second-guessing about their marketing decisions by MMS during audit.¹ For lessees selling to affiliates which engage in midstream activities, the duty to market cannot be used to effectively tax the value added by a separate line of business downstream from the lease.

3. RESPONSES OF DPC MEMBERS TO MMS QUESTIONS.

¹ Although MMS claims it will not use the duty to market to second guess a lessee's gross proceeds, the new regulations should be clear on this point. MMS is currently using the duty to market to claim additional royalties even under arm's-length sales. *See Amerac Energy Corp.*, MMS-93-0868-OCS (1996), *on appeal* IBLA 97-118.

The DPC surveyed its members on specific questions raised by the MMS. The members' responses demonstrate that: (1) DPC member companies have almost no crude oil production subject to exercised "non-competitive" calls, or those specifying postings as the price that will be paid for the oil, thereby preventing receipt of "market" prices; and (2) there was no meaningful information obtained on publicly available pricing information in the Rocky Mountain region.

4. THE MOST EFFECTIVE WAY TO ASSURE THAT THE TREASURY IS RECEIVING FAIR VALUE WHILE REDUCING AUDIT BURDENS AND SIMPLIFYING THE SYSTEM IS TO TAKE ROYALTIES IN KIND.

In the September 22 notice and throughout the workshops, the key question asked by MMS's participants was whether each of the various proposals would simplify the agency's audit burden. MMS may believe it is worthwhile to sacrifice accuracy in determining the value of production to reduce auditing. But no sacrifice is necessary. MMS can dramatically reduce audit burdens, bring simplicity to royalty management, and assure the accuracy of its value determinations. Royalty in kind achieves all three goals. MMS's rulemaking on oil valuation is nothing more than a labored struggle to find what method of valuing royalty might be second best.

CONCLUSION

DPC thanks MMS for holding its workshops. They were a useful start in furthering discussions among the federal government, state governments, and federal lessees. With continued effort by all parties, DPC believes that it is possible for MMS to publish a regulation with the many difficult issues resolved through finely-tuned provisions. Such a rule would then give MMS the time it needs, free of contention, to implement a full royalty-in-kind program.

Sincerely,



J. Larry Nichols
Chairman

MIDSTREAM ACTIVITIES

Marketing

- Aggregating Volumes for Barrel Availability
- Satisfying Specialized Customer Quality Preferences
- Scheduling Monthly Crude Business through Contracted Companies and Pipelines
- Crude Movement Flow Schedule for Accounting
- Review Financial Analysis of Trades
- Review of Contracts and Other Marketing Arrangements vs. Current Markets
- Development of Monthly Market Differentials
- Obtain and Analyze Crude Oil Samples

Operations

- Contracting for or Providing Transportation
- Scheduling of Volumes
- Providing Pipeline Fill
- Tracking Volumes Delivered
- Providing Credit Services
- Constructing or Leasing Storage Facilities
- Scheduling Storage Volumes
- Maintaining Inventory
- Environmental and Safety Compliance

Risk Management

- Dealing with Price Fluctuations at or Upstream of Market Centers
- Risk or Loss of Pipeline Volumes
- Environmental Liabilities for Spills
- Risk of Purchasers' Default

Administration

- Contract Preparation and Follow through with Outside Company
- Contract Maintenance
- Royalty Bonus Development and Application
- Oil Price Development
- Inventory Reconciliation
- Disbursement Activities (Division Order, Tax, Legal)